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Supreme Court, U.S.
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No. 02-1196

In The
Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION,

Petitioner,

v.

CHARLES E. EDWARDS,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

BRIEF IN OPPOSITION

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QUESTION PRESENTED

Section 2(a)(1) of the Securities Act of 1933, 15 U.S.C. § 77b(a)(1), and Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10), include the term "investment contract" in the definition of "security." This Court has defined an investment contract to comprise an investment of money in a common enterprise with profits to be derived solely from the efforts of others. This Court has further explained that the term "profits" in the investment contract context means only capital appreciation from the development of the initial investment or a participation in earnings resulting from the use of investors' funds. This case concerns the purchase by individuals of pay telephone equipment and their subsequent lease of that equipment in exchange for monthly fixed lease payments. The question presented is: Did the court of appeals err when it held that the monthly fixed lease payments were not "profits" for investment contract purposes where the fixed lease payments represented neither capital appreciation nor a participation in the earnings of the enterprise?

RULE 29.6 STATEMENT

Pursuant to Supreme Court Rule 29.6, Respondent Charles E. Edwards submits that he does not have any parent corporations or subsidiaries.

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BRIEF IN OPPOSITION

Charles E. Edwards respectfully submits his Brief in Opposition to the Petition for Writ of Certiorari filed on behalf of the Securities and Exchange Commission ("SEC"), to review the judgment of the United States Court of Appeals for the Eleventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals is reported at 300 F.3d 1281 and is reproduced at Pet. App. 1a-15a. The order denying rehearing and rehearing *en banc* is reproduced at Pet. App. 28a-29a. The order of the district court is reported at 123 F. Supp. 2d 1349 and is reproduced at Pet. App. 16a 27a.

JURISDICTION

The judgment of the court of appeals was entered on August 6, 2002. The SEC's petition for rehearing and rehearing *en banc* was denied on November 15, 2002. The SEC's petition for writ of certiorari was docketed on February 14, 2003. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

The text of 15 U.S.C. § 77b(a)(1) and 15 U.S.C. § 78c(a)(10) are reproduced at Pet. App. 30a-31a.

STATEMENT

Charles E. Edwards was the founder and controlling shareholder of ETS Payphones, Inc. ("ETS"), a Georgia corporation. ETS has been engaged in the business of operating coin-operated pay telephones since approximately 1994. Mr. Edwards was a member of ETS's board of directors and served as its chief executive officer until June 2000. ETS was one of the largest privately-owned pay telephone operators in the United States. As the SEC conceded in the court of appeals, ETS had 28 offices nationwide and four in Mexico and was managing 47,000 payphones in 38 states in locations such as fast food restaurants, convenience stores, gas stations, hotels, airports, and sports arenas. (SEC App. Br. at 5-6); *see also SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1288 (11th Cir. 2002). (Pet. App. 14a). (Lay, J., concurring). ETS has recently emerged from bankruptcy and currently owns and operates a system consisting of tens of thousands of pay telephones.

ETS presented pay telephone owners with three options regarding the services ETS offered. Two of these options, not at issue here, provided the pay telephone owner with a share in the profits of his or her particular pay telephone and, for a fee, ETS performed various management and maintenance duties. The third option was a lease plan. The lease option, the only plan relevant here, did not include any sharing in the profitability of ETS or the pay telephone.

Mr. Edwards otherwise incorporates by reference the statement of the facts by the court of appeals, reproduced at Pet. App. 2a-4a, as his statement of facts regarding ETS's business operations relevant to the question presented.

On November 22, 2000, the district court granted the SEC's emergency petition for a preliminary injunction, an asset freeze and other equitable relief against Mr. Edwards.[1] Even though Mr. Edwards pointedly raised the SEC's failure to prove that the monthly lease payments by ETS to pay telephone owners were a species of "profits" necessary to establish the existence of an investment contract (R2-11-21), the district court did not address the issue.

On appeal, the court of appeals reversed the order of the district court and held that the district court lacked subject matter jurisdiction to entertain the action because the SEC could not satisfy one of the essential elements of an investment contract under the test set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946): the expectation of profits to be derived solely from the efforts of others. The court of appeals reasoned that the SEC could not reasonably demonstrate that the pay telephone owners, who had individual lease contracts with ETS, expected "profits" as that term was defined in *United Housing Found., Inc. v.*

[1] ETS, which was in bankruptcy, consented to the entry of a preliminary injunction before the evidentiary hearing on the SEC's motion.

Forman, 421 U.S. 837 (1975). Citing the test announced in *Forman* for "profits," which the SEC too had relied upon, the court of appeals reiterated that the definition of profits in the context of investment contracts requires either a participation in earnings by the investor or capital appreciation. *SEC v. ETS Payphones, Inc.*, 300 F.3d at 1284. (Pet. App. 6a).[2] The court stated that "there is no dispute that capital appreciation is not at issue." *Id.* (Pet. App. 7a). The court reasoned further that the fixed lease payments were not a participation by the pay telephone owners in company earnings or losses, stating that "[b]ecause the investors received a fixed monthly sum, the actual earnings of their telephone, or ETS, were irrelevant." *Id.* at 1285. (Pet. App. 7a). The court of appeals concluded its "profits" analysis by stating that "only ETS could reap profits as that term is understood under the federal securities law." *Id.* Finally, the court noted, in *dicta*, that even if lease payments were a participation in profits, the third prong of the *Howey* test was still not satisfied because the rental payments "were derived as the benefit of the investors' bargain under the contract." *Id.* The court of appeals did not address whether the common enterprise

[2] The court of appeals determination that there was no subject matter jurisdiction was based on the evidentiary record compiled in the district court on the motion for a preliminary injunction and was not the result of a motion to dismiss addressed merely to the SEC's complaint. Thus, the SEC's references to the unsupported allegations of its complaint in the SEC's "Statement" (SEC Petition at 3-4) are not allegations that must be deemed true and should be disregarded. For example, the SEC's "facts" that as a result of misleading marketing ETS took in approximately $300 million from more than 10,000 investors or that Mr. Edwards "drained approximately $18 million from the company in direct compensation" has never been proven or found by any court.

prong of the *Howey* test was met since the last prong was clearly unsatisfied. *See id.* at 1284. (Pet. App. 6a). Judge Lay, in his concurring opinion, concluded that the SEC also had not shown a common enterprise, and stated that, contrary to the SEC's argument that ETS was a "Ponzi" scheme, and therefore fraudulent, the evidence showed that Mr. Edwards had made a good faith effort to run a legitimate business. *See id.* at 1288. (Pet. App. 14a). The court of appeals did not consider the other grounds of error presented by Mr. Edwards.

The SEC's petition for rehearing was denied. As no judge in regular active service on the court requested that the court be polled on rehearing *en banc*, its petition for rehearing *en banc* was also denied.

REASONS FOR DENYING THE WRIT

The decision of the court of appeals is consistent with prior decisions of this Court, is not in conflict with any other court of appeals, and is correct. Further review by this Court is therefore unwarranted.

The court of appeals applied the established rule of law set forth in *United Housing Found. Inc. v. Forman*, 421 U.S. 837 (1975), the limits of which were emphasized in *Reves v. Ernest & Young*, 494 U.S. 56 (1990), regarding what "profits" are for purposes of defining an investment contract under the well-recognized rubric of *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The factual circumstances of the particular business venture involved here simply do not fit within the elements of an investment contract, specifically the third element, the expectation of profits derived from the efforts of others. At most, the asserted

error consists of the misapplication of a properly stated rule of law to those circumstances. The SEC's effort to expand the scope of the term investment contract into a "catch-all" provision of the federal securities laws in order to avoid the limits imposed by *Forman* and *Reves* is unprecedented.[3] Contrary to the SEC's contentions, there is no conflict with decisions of the Third Circuit or Ninth Circuit Courts of Appeals, this Court's own precedent, or previous SEC authoritative opinions and positions. Finally, the court of appeals decision does not impede or impair the SEC's ability to enforce the securities laws. In fact, the SEC filed and has successfully pursued a case virtually identical to the ETS case in the same district court some four months after the court of appeals decision. *See SEC v. Zanello*, Civil Action No. 02-CV-3308 (N.D. Ga. Dec. 10, 2002).

I. The Court of Appeals Decision Is Consistent With The Court's Prior Decisions.

"Investment contract" is one of the general categories listed under the definition of "security," *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 691 n.5 (1985), and has

[3] Assuming *arguendo* that the SEC's claims of misrepresentation by ETS in its payphone business had merit, those claims would not justify the uncabined rule sought by the SEC. As the Court has observed, "congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud." *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982) (citations omitted). ETS has always been subject to regulation by the Federal Trade Commission ("FTC"). The FTC's disclosure regulation rule "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures," *see* 16 C.F.R. § 436, applied to the disclosures and transactions described here and was followed by ETS. (Exh. 18; R2-11-23).

been used by the Court to identify "unusual instruments that did not fit squarely within one of the enumerated specific kinds of securities listed in the definition." *Id.* at 689 n.4. In assessing whether one of these "unusual instruments" was an investment contract, the Court has applied an economic reality test, for, if the securities Acts were to apply in those cases at all, it would have to have been because the economic reality underlying the transactions indicated that the instruments were actually of a type that falls within the usual concept of a security. *See id.* at 690. By 1933, the term's meaning had been crystallized by prior usage to the extent that Congress's use of the term had meaning. In accord with this historical treatment, the Court held that investors expecting capital appreciation from a business venture involving the sale of oil leaseholds, *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), and investors expecting to share in the earnings of an orange grove venture, *Howey*, 328 U.S. 293, had acquired investment contracts, even though the interests they acquired were not one of the more traditional species of securities.

In *Howey*, the Court established, for federal law purposes, a three-part test for determining whether particular financial relationships are investment contracts. The Court held in *Howey* that there must be an investment of money in a common enterprise with an expectation of profits to be derived solely from the efforts of others. *Howey*, 328 U.S. at 301. With respect to what constituted "profits," the *Howey* Court was specific; it stated that the investors' "respective shares in [the] enterprise are evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors' allocable shares of the profits. . . . Thus, all the elements of

a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits. . . . " *Howey*, 328 U.S. at 300, 301.

In *Forman*, the Court explained what the term "profits" means in the investment contract context:

> By profits, the Court has meant either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds. . . .

Forman, 421 U.S. at 852 (citations omitted).[4] If any doubt remained as to what the Court meant by "profits" in the investment contract context, those doubts were put to rest in the unanimous portion of the Court's decision in *Reves v. Ernst & Young*, 494 U.S. 56 (1990). The Court was unmistakably precise: it reiterated that the Court had "defined 'profit' more restrictively in applying the Howey test to what are claimed to be 'investment contracts,'" to encompass only capital appreciation and a participation in earnings, whereas the definition of "profit" in the context of "notes" was broader, meaning a valuable return on an investment, undoubtedly including interest. *Id.* at 68 n.4. The Court expressly "decline[d] to extend [*Howey's*] definition of 'profit' beyond the realm in which the definition applies" because the issue was not before the Court. *Id.*

[4] The dissent in *Forman* emphasized that the Court's restrictive definition of "profits" would exclude some forms of investments from the *Howey* test: the "Court must surprise knowledgeable economists with its proposition . . . that profits cannot assume forms other than appreciation of capital or participation in earnings." *Forman*, 421 U.S. at 863. (Brennan, J., Douglas, J., and White, J., dissenting).

The Court also pointed out that categories of securities not subject to this "restrictive definition" of "profit" were not required to have a return on investment "keyed to the earning of the enterprise." *Id.*

In its brief to the court of appeals, the SEC posited the *Forman* profits definition as the correct test, stating that profits are either the result of the appreciation of capital from the development of an initial investment or are a participation in earnings resulting from the use of investors' funds. (SEC App. Br. at 36). The SEC has never contended that lessors to ETS expected capital appreciation, and the SEC's only evidence of a participation in earnings by lessors was their receipt of their monthly lease payments, which the SEC argued were *Howey*-type profits, even though they were not "keyed" to ETS's earnings. Based on these facts, as noted above, the court of appeals disagreed with the SEC, and concluded that the SEC had not proven that lessors expected *Howey*-type profits. *SEC v. ETS Payphones, Inc.*, 300 F.3d at 1285. (Pet. App. 6a).

Obviously disappointed by that result, the SEC in its Petition now contends that the legal test applied by the court of appeals, fashioned as it was from consistent, long-standing and unquestioned precedent, amounted to "engrafting rigid technical limits" on the *Howey* test (SEC Petition at 13) and was "mistaken." (SEC Petition at 17). The SEC argues that one may participate in the earnings of an enterprise when that participation is not "measured" by the earnings; however, the SEC concedes, as it must, that its position is directly contrary to the Court's unanimous position in *Reves*. (SEC Petition at 18-19 n.6). In fact, the SEC now says that the Court in *Forman* was "simply describing one of its prior decisions" (SEC Petition

at 18) and the Court in *Reves*, like the court of appeals, was "mistaken." (SEC Petition at 19 n.6). In short, the SEC is seeking to extend the Court's definition of "profits" beyond the realm in which the definition applies.[5]

The SEC's effort to overcome this well-established meaning of "profits" for investment contract purposes is anchored by the SEC's contention that the term investment contract is a "catch-all" for all manner of investments not otherwise defined as securities. (SEC Petition at 12,[6] 13). By arguing that the term investment contract is a "catch-all," the SEC tacitly concedes that the facts here do not meet the well-established elements long recognized by this Court and the lower courts to determine the existence of an investment contract. Since first addressing the meaning of investment contract in the securities context fifty years ago, the Court has refined, explained and applied the contours of the term numerous times. Not once has the Court departed from the essential elements established in *Joiner* and *Howey*, or described the term investment contract as a "catch-all." Here, the SEC invites

[5] The SEC's position ignores the basic tenet that "settled construction of an important federal statute should not be disturbed unless and until Congress so decides." *Reves*, 494 U.S. at 74 (Stevens, J., concurring) (further commenting that after a statute is construed by the court or a course of other federal decisions (*see* pages 19-20, *infra*) "it acquires a meaning that should be as clear as if the judicial gloss had been drafted by the Congress itself").

[6] The support for its argument that the term is a "catch-all" is the SEC's citation to an off-hand comment in *Golden v. Garafalo*, 678 F.2d 1139, 1144 (2d Cir. 1982) that uses the term "catch-all." (SEC Petition at 12). In that case, the court did not suggest that an investment contract did not have the defined elements identified by this Court's decisions.

the Court to determine for the first time that the term investment contract is a "catch-all" broad enough to "catch" transactions having some of the attributes of other distinct types of securities (here fixed periodic payments, which are characteristic of notes and other debt instruments) and not having those attributes historically associated with investment contracts, *to wit*, either an opportunity to attain capital appreciation or to share in the earnings of the common enterprise.[7]

In its zeal to convince this Court that the court of appeals erred, the SEC has lost sight of the issue in this case. It poses the question presented and argues repeatedly as though the court of appeals held that fixed returns could never be *Howey*-type profits. This mischaracterizes the holding of the court of appeals. It did not, as the SEC contends, hold "that an investment cannot be an 'investment contract' if the return is fixed rather than variable or if the investor is contractually entitled to a particular amount or rate of return." (SEC Petition at 9.) Rather, the court of appeals stated that "capital appreciation is not at issue" and held that "the fixed lease payments paid to owners of the telephones cannot be considered participation in earnings; owners were not looking for any profit in

[7] Both the Securities Act's and the Securities Exchange Act's definition of "security" do include what can be deemed "catch-all" terms: " . . . or, in general, any interest or instrument commonly known as a 'security' . . . " (15 U.S.C. § 77b(a)(1)); " . . . or in general, any instrument commonly known as a 'security' . . . " (15 U.S.C. § 78c(a)(10)). By preceding the definition of "security" in both Acts by the preface " . . . 'unless the context otherwise requires' . . . ," Congress sought to avoid the unfettered usage for the listed terms urged by the SEC. *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982) (citations omitted).

the sense that they would receive earnings from the company." *SEC v. ETS Payphones, Inc.*, 300 F.3d at 1284. (Pet. App. 7a). The necessity for a variable return was not a question posed to or decided by the court of appeals.

The question presented by this case that determines the presence of federal jurisdiction is whether the lease payments here satisfy the definition of profits established by *Forman* and solidified by *Reves*. The SEC protests too much in claiming that the court of appeals' decision, "opens a seemingly limitless gap" in investor protection against fraud (SEC Petition at 8) and "opens an immense loophole in the definition of security" (SEC Petition at 13) by eliminating from coverage promoters' offerings that carry a fixed or specified, rather than a variable, return. Despite this hyperbole, the decision did not turn on whether the payments were fixed or variable and no loophole was opened. In contending that the Court should take this case to hold that a fixed payment not derived from capital appreciation or a participation in earnings is a *Howey*-type profit, the SEC does not write on a clean slate: this same position was advanced by the SEC in its *amicus* brief in *Reves* (Br. for the SEC as Amicus Curiae Supporting Pet'rs at 28, *Reves*, *supra* (No. 88-1480)); nevertheless, the Court unanimously and explicitly announced a contrary view. Nothing in the law has changed to suggest that the SEC is any more correct in this position now than it was then. On several other occasions, this Court has rejected the SEC's efforts to extend the realm of *Howey*. *See, e.g., Int'l Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 566 n.20 (1979) (citing cases). It should do so again. In this case, the court of appeals applied an established and correct rule of law and its decision should not be disturbed.

In seeking to extend the definition of "profits," the SEC points to the literal meaning of "guaranty," "invest," "investing," "income," "contract," and "profit." (SEC Petition at 10-11). But, the mature and developed jurisprudence of what constitutes an investment contract counsels against " . . . mak[ing] a fortress out of the dictionary." *Cabell v. Markham*, 148 F.2d 737, 739 (2d Cir. 1945) (L. Hand, J.), *aff'd*, 326 U.S. 404 (1945); *Public Citizen v. U.S. Dept. of Justice*, 491 U.S. 440, 454-55 (1989) (explaining that the plain meaning rule in statutory construction is "rather an axiom of experience than a rule of law, and does not preclude consideration of persuasive evidence if it exists") (citations omitted). The Court's teachings stress that an examination of economic realities underlying a transaction, in light of the purposes of the securities laws, will identify what is or is not an investment contract. *Forman*, 421 U.S. at 849. The economic realities of the ETS business enterprise presented by the record here show that lessors parted with their money to acquire a pay telephone to use for commercial purposes and then they entered into a lease agreement providing for a fixed monthly payment, an expense which ETS could pay from many sources, not "keyed" to ETS's or the pay telephones' earnings, such as revenues, borrowings, asset sales, payments from a subsidiary, or otherwise. Earnings of the business would be available only after its expenses were paid.

Confronted by its lack of proof of a "profit" expectation by lessors, which it characterizes as investors, the SEC shifts the focus and contends that, according to *Reves*, Congress's goal was to regulate investments in whatever form they are made and by whatever name they are called.

For proof that these were "investments" promising "profits," the SEC argues that the marketing materials allegedly used by ETS to sell pay telephones should control as to whether profits were expected by lessors for *Howey* purposes, citing *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) and *SEC v. United Benefit Life Insur. Co.*, 387 U.S. 202 (1967). (SEC Petition at 16-17). Putting aside the fact that the SEC inaccurately describes the marketing materials, who used them, and to whom they were directed, the Court has not used marketing materials as the sole test of whether a particular instrument is an investment contract.[8] Rather, the Court has "repeatedly held that the test '"is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."'" *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982), citing *SEC v. United Benefit Life Insur. Co.*, 387 U.S. 202, 211 (1967) and *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-353 (1943). Here, the instruments

[8] The SEC's reliance on marketing materials that read "watch the profits add up" and described "steady immediate cash flows" is misplaced. (SEC Petition at 3, 17). Those materials (Exh. 17, 22) were directed to property site owners, such as convenience store owners, who were solicited to have pay telephones installed on their property and who would receive a share of the installed pay telephones' revenues, or were used to market ETS's management services and not the lease option. (R11-59). Other marketing materials referenced by the SEC (Exh. 15) were not used by ETS (R11-59) or were withdrawn from evidence by the SEC for lack of foundation (Exh. 14) and thus are not part of the record. (R11-100). The ETS marketing materials for the lease plan stated that ETS's profits or the individual lessor's pay telephone revenues were separate from the monthly rental amount that was to be paid to the lessor as rent. (Exh. 18). The SEC thus paints with too broad a brush in contending that lessors were told they were able to share in any "profits." (SEC Petition at 17).

were in fact lease agreements, were offered and executed as lease agreements, and the economic inducement was a fixed monthly lease payment. These were not "unrealistic and irrelevant formulae." *Howey*, 328 U.S. at 301. That other options for commercialization of pay telephones were discussed in the ETS marketing materials and were offered to pay telephone owners does not alter the essential attributes of the instruments involved here. Despite the inaccurate descriptions by the SEC of these marketing materials, the fact of the matter is that the pay telephone owners involved in this case chose the option offered by ETS that gave them nothing more than an expectation of a fixed monthly rental payment in exchange for ETS's use (or even non-use) of their pay telephones.

After holding that the lease payments were not profits under the *Forman* formulation, the court of appeals observed that the final prong of *Howey* was not satisfied in any event "because the investors did not expect profits to be derived solely from the efforts of others." *SEC v. ETS Payphones, Inc.*, 300 F.3d at 1285. (Pet. App. 7a). According to the court of appeals, "the determining factor [was] the fact that the investors were entitled to their lease payments under their contracts with ETS" and the returns were "derived as the benefit of the investors' bargain under the contract." *Id.* The lessors stood to recover no more nor less than the lease payments and ETS's efforts, or lack of them, could not change that amount or alter the lessors' rights under the agreement. Once the lessors agreed to lease their pay telephones to ETS, the lessors retained the ability to terminate their agreements, switch to a management plan, repossess their pay telephones, contract with one of the many other pay telephone management companies (R11-52-53), assign their interests, or

sell their pay telephones at the purchase price (on 180 days' notice or after the five-year term of the lease) to ETS, or someone else at market price. And, because these were lease agreements, the district court's findings that ETS "assumed all responsibility for the payphones" and the "[i]nvestors never saw the telephones, never used the telephones, and often did not know where they were located," *SEC v. ETS Payphones, Inc.*, 123 F. Supp. 2d 1349, 1354 (N.D. Ga. 2000) (Pet. App. 22a), were truisms simply irrelevant to the analysis. The court of appeals *dicta* complained of by the SEC was consistent with *Howey*.[9]

II. The Court of Appeals Decision Does Not Present A Conflict Among The Courts of Appeals.

The SEC's Petition should be denied because there is no intercircuit conflict. Among *SEC v. The Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), *United States v. Carman*, 557 F.2d 556 (9th Cir. 1978), and this case there are factual differences, but the rule of law applied by the courts is the same despite the SEC's attempts to place them in conflict. The fact that *Infinity Group* and *Carman*

[9] The claim in the Petition that the court of appeals should have *sua sponte* remanded this case to the district court to consider whether the instruments here were "notes" or other "evidences of indebtedness" is without merit. (SEC Petition at 20 n.7). First, there was no note and the lease agreements do not meet the legal test for notes. Second, and more importantly, neither the SEC's complaint and its proofs at hearing nor its brief to the court of appeals even mentioned the theory that these were notes or other evidences of indebtedness. Neither the district court nor the appellate court entertained this contention. Thus, neither should this Court.

stated that the return on investment was "fixed" was not controlling as to their respective decisions that the *Howey* test had been met.[10]

Carman did not even mention Forman or its "profits" formulation. *Carman's* focus was to determine if a common enterprise was present, finding one because the success of both promoter and investor, despite the latter's fixed return, was dependent upon the promoter's continued solvency. *Carman*, 557 F.2d at 563. *Carman* does not, as the SEC suggests (SEC Petition at 22), lend support to its argument for an extension of the "profits" aspect of the *Howey* test. Subsequent Ninth Circuit decisions have cited the language from *Carman* relied upon by the SEC, but only with reference to the common enterprise element of the *Howey* test. *See SEC v. Eurobond Exchange, Ltd.*, 13 F.3d 1334, 1340 (9th Cir. 1994); *SEC v. Goldfield Deep Mines Co. of Nevada*, 758 F.2d 459 (9th Cir. 1985); and *Brodt v. Bache & Co., Inc.*, 595 F.2d 459, 461 (9th Cir. 1978). Two years after *Carman*, the same court, in *Noa v. Key Futures, Inc.*, 638 F.2d 77, 80 (9th Cir. 1980), established that the risk of insolvency alone is insufficient to establish the requisite dependency for a common enterprise. *See SEC v. Belmont*

[10] Both cases relied upon *El Khadem v. Equity Securities Corp.*, 494 F.2d 1224 (9th Cir. 1974), *cert. denied*, 419 U.S. 900 (1974), a pre-*Forman* case that relied upon promised tax benefits as a type of profit meeting the *Howey* test, a notion discredited by *Forman*. *Forman*, 421 U.S. at 855 n.20. In any event, the court in *El Khadem* expressly stated that its holding did not apply to cases where the investor "borrower" seeking tax benefits would not face an out-of-pocket loss in return for financial gain, such as where the investor's collateral could be redeemed. *El Khadem*, 494 F.2d at 1230 n.14. Here, the lease agreement provided that the pay telephone owner could repudiate the lease agreement and reclaim his or her pay telephone at any time.

Reid & Co., Inc., 794 F.2d 1388, 1391 (9th Cir. 1986) (also citing *Noa* and noting that the greatest risk to the purchaser was the failure of the enterprise but that this was insufficient to meet the third prong of *Howey* because of its ready applicability to any sale-of-goods contract).

Infinity Group noted that the defendants did not contest the "third prong[ ] of the *Howey* test" and, after a cursory treatment that did not mention *Forman*, agreed that the profits from the efforts of others element was met. *SEC v. The Infinity Group Co.*, 212 F.3d at 187. The "focus [of its] analysis [was] upon the 'common enterprise,' or second prong, of the *Howey* test." *Id.* In this analysis, the *Infinity Group* court looked to the *Forman* "profits" formulation to determine if the investment scheme involved a "common enterprise," concluding that it did because the profits of the enterprise were shared, with a set percentage amount going to the investors. As the Petition notes, purchasers of the property transfer contracts in the *Infinity Group* case parted with their money to be pooled in trusts and invested at the trustee's discretion. (SEC Petition at 21). The "guarantee" or fixed return that the SEC points to as an inter-circuit conflict misses a step in the *Forman* profit analysis. The guarantee that the investors would be paid a portion of the trust's earnings as dividends ranging between 138% to 181% of their investment amount is pointedly different than the expectation that ETS would pay the expenses associated with its fixed lease obligations on the pay telephones. *SEC v. The Infinity Group Co.*, 212 F.3d at 184. In the former, even though fixed in percentage, the dividend derived from a participation in the earnings of the trust. The representations that investors could expect a specific percentage gain in the form of dividends only reinforces the view that these

were payments to be made as a result of earnings on the investors' funds, a fact that fits squarely within *Forman's* definition of profits.

Soon after *Forman* was decided, the court in *SEC v. Energy Group of America, Inc.*, 459 F. Supp. 1234 (S.D.N.Y. 1978), citing *Forman*, held, as did the court below, that the SEC was not entitled to a preliminary injunction as the instruments involved were not investment contracts; they did not fall in one of the two categories of cases that typified all investment contracts:

> cases where investors contributed capital to an enterprise expecting a participation in earnings resulting from the use of their funds, or as cases where tangible or intangible property was purchased by the investor in the expectation that it would appreciate in value, either because of the promoter's expertise in selecting the property or because of the promoter's managerial or entrepreneurial efforts subsequent to the purchase of the property.

Id. at 1241. The SEC did not appeal. The numerous cases cited by the SEC (SEC Petition at 15 n.4) demonstrate that this categorization was correct: *Capital Appreciation*: *United States v. Jones*, 712 F.2d 1316 (9th Cir. 1983), *cert. denied*, 464 U.S. 986 (1983); *Smith v. Gross*, 604 F.2d 639 (9th Cir. 1979); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974); *Glen-Arden Commodities, Inc. v. Costantino*, 493 F.2d 1027 (2d Cir. 1974); *Kemmerer v. Weaver*, 445 F.2d 76 (7th Cir. 1971), and *Continental Mktg. Corp. v. SEC*, 387 F.2d 466 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968); *Participation in Earnings*: *Bailey v. J.W.K. Prop., Inc.*, 904 F.2d 918 (4th Cir. 1990); *Long v. Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989);

Albanese v. Florida Nat'l Bank, 823 F.2d 408 (11th Cir. 1987) and *Blackwell v. Bentsen*, 203 F.2d 690 (5th Cir. 1953), *cert. dismissed*, 347 U.S. 925 (1954).

Four other courts of appeals' decisions, relying upon *Forman*, have concluded, as did the court below, that the "profits" element of *Howey* is not met by a fixed payment that is not derived from capital appreciation or a share of company earnings. In all of these cases, there were contractual arrangements whereby one party was relying upon another party's performance under that contractual arrangement, but none of these cases satisfied the expectation of profits from the efforts of others test. *See Resolution Trust Corp. v. Stone*, 998 F.2d 1534 (10th Cir. 1993); *Union Planters Nat'l Bank of Memphis v. Commercial Credit Bus. Loans, Inc.*, 651 F.2d 1174 (6th Cir. 1981), *cert. denied*, 454 U.S. 1124 (1981); *Kansas State Bank v. Citizens Bank*, 737 F.2d 1490 (8th Cir. 1984); *American Fletcher Mortgage Co. v. United States Steel Credit Corp.*, 635 F.2d 1247 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981).

Speculative or non-speculative, variable or fixed, these lower courts have held that the amounts received ultimately must be either capital appreciation or earnings contingent on the use of investors' funds to be *Howey*-type profits. In sum, there has been a consistent course of federal decisions adhering to the Court's construction in *Forman* and there is no inter-circuit conflict that warrants the Court's review of the decision below.

III. The Court of Appeals Decision Does Not Depart From SEC Precedent Entitled to Deference.

Finally, review by this Court is not necessary because the court of appeals decision does not conflict with any longstanding SEC interpretation of the securities laws to which deference should be paid, and the decision has not impaired the SEC's ability to enforce these laws. As noted above, in December 2002, on the heels of the denial of its petition for rehearing and rehearing *en banc*, the SEC filed a complaint for preliminary injunctive and other relief in the Northern District of Georgia alleging securities laws violations in a case with facts indistinguishable from those in the case brought against Mr. Edwards and ETS. *See SEC v. Zanello, et. al.*, Civil Action No. 02-CV-3308 (N.D. Ga. Dec. 10, 2002). There is no gap in the SEC's enforcement abilities. And contrary to the SEC's suggestion, the several enforcement actions it lists in its Petition would not be precluded, if otherwise appropriate, by the court of appeals ruling in this case. (SEC Petition at 25-26).[11]

The SEC's claim that its Petition is worthy because the court of appeals opinion contradicts a longstanding and consistent SEC approach to this issue also does not

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[11] *SEC v. Amtel Communications, Inc.*, 60 S.E.C. Dkt. 1753 (Nov. 7, 1995), the case which the SEC asserts involves a pay telephone business "like the one in this case" (SEC Petition at 25), resulted in the denial of the SEC's motion for a preliminary injunction in August 1995 (Civil Docket No. 95-CV-1127, S.C. Ca. 1995). This fact was omitted from the November 7, 1995, SEC "Litigation Release" cited by the SEC. Thereafter, the SEC amended its complaint and the case settled. The 2002 cases cited by the SEC involve a participation in earnings or a type of security other than an investment contract.

bear scrutiny. In 1978, the SEC's enforcement action in *SEC v. Energy Group of America*, 459 F. Supp. 1234 (S.D.N.Y. 1978), discussed above, was dismissed as a result of the failure of the SEC to meet the *Forman* profits formulation. It did not appeal. As the SEC notes (SEC Petition at 24), as *amicus* in *Reves* it took the same position it has here. Its views were rejected by the Court. *Reves*, 494 U.S. at 68 n.4. Some six years later, in 1995, the SEC investigated the ETS pay telephone program, including the marketing and leasing aspects of the business. *SEC v. ETS Payphones, Inc.*, 300 F.3d at 1282 n.1. (Pet. App. 3a n.1). During the ensuing five years, until 2000, the SEC did not take the position with ETS that it has here. The SEC has not been consistent in its application of the view expressed here.[12]

The SEC's claim to a long-standing, adjudicated interpretation applying a "profits" test less stringent than the court of appeals holding and the *Forman* profits formulation, based on the pre-*Forman* SEC opinion in *In re Abbett, Sommer & Co.*, 44 S.E.C. 104 (1969), fares no better. In that case, the SEC did "not consider it significant" that the services provided by the promoter were not designed to create a profit, but merely were directed towards minimizing risk. *See id.* at *4. In another so-called

[12] The SEC has also presented inconsistent positions regarding another aspect of the *Howey* test, the common enterprise element, an issue in the court below. In the district court, the SEC urged "broad vertical commonality" as "black letter law." (R11-105) "[I]n its arguments in a case out of the First Circuit, the SEC concedes . . . broad vertical commonality is an inappropriate test for *Howey's* common enterprise requirement." *SEC v. ETS Payphones, Inc.*, 300 F.3d at 1286. (Pet. App. 10a). (Lay, J., concurring).

"adjudication" pointed to by the SEC, *In re Union Home Loans*, 26 S.E.C. Dkt. 1346 (Dec. 16, 1982) *available in* 1982 WL 522493, the case settled without a hearing or the presentation of evidence and the SEC announced its views in a report of investigation, not an adjudicatory opinion in a contested case.

CONCLUSION

The Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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